Section 506 Restrictions on Development Company Assistance

April 22, 1991

MEMORANDUM FOR: All Regional Administrators
All Regional Directors for CPD
All Category A Field Office Managers
All CPD Division Directors

FROM: Anna Kondratas, Assistant Secretary for Community
Planning and Development, C \s\

SUBJECT: Section 506 Restrictions on Development Company Assistance On or After May 1, 1991

Section 506 of the Small Business Investment Act of 1958 (SBI Act), provision 1, as implemented in 13 CFR 108.506, prohibits a certified development company (CDC), on or after May 1, 1991, from accepting funding that imposes conditions on the types of small businesses that may receive Small Business Administration (SBA) loans or on the recipient of SBA Loans. Community Development Block Grant CDBG) recipients that have SBA CDC subrecipients need to be aware of the limitation imposed by 13 CFR 108.506 and the prohibition of superimposing other restrictions over the SBA 504 Loan Program.

Title I of the Housing and Community Development Act of 1974 (HCD Act) requires that each activity assisted in whole or in part with CDBG funds must meet one of three national objectives. Where CDBG funds are made available by HUD grantees to local development companies for some or all of the costs of administering a loan to a business(es)(an activity that is eligible under section 105(a)(17) of the HCD Act), the loan is CDBG-assisted, even where no CDBG funds are being used for the loan itself, and must therefore meet a national objective. With respect to loans made with SBA funds (as opposed to some other funding source, including CDBG), the national objective requirement would result in a violation of section 506.

Therefore, subject to the exception described below, SBA CDC's may not accept any further CDBG funds after May 1, 1991, for purposes of paying administrative costs, although CDBG funds obligated to SBA CDC's by a subrecipient agreement entered into prior to that date may be expended by the CDC for this purpose.

An SBA CDC may receive CDBG funds after May 1, 1991, without violating the Section 506 prohibition if it adopts a method of allocating administrative costs under which the CDBG expenditures for such costs are not chargeable to loans made with SBA funds.

Two basic methods are available for allocating costs to the CDBG program. One method would be to have the CDC staff maintain detailed daily time distribution records that document the time worked on each loan or category of loans. This would allow the CDC to identify the direct salaries and wages chargeable to non-SBA activities. However, indirect costs of the CDC could not be allocated to non-SBA activities under this method.

To recover the indirect costs, the CDC would have to prepare a cost allocation plan in accordance with OMB Circular A-122. Indirect costs allocable to activities other than loans made with SBA funds could be recovered from CDBG funds by applying an indirect costs rate (as established by the cost allocation plan) to an allocation "base." The allocation base in this case would be the direct salaries and wages.

A second method for allocating costs to the CDBG program would be to treat all costs of the CDC, other than loans, as indirect. Under this method the allocation base could be the number of loans originated, if that would result in an equitable distribution of indirect costs. (That is, the amount charged to the CDBG program would be determined by applying a rate equal to the number of loans made with non-SBA funds divided by the total number of loans made.)

Under either method, the cost allocation process must provide for an adjustment after the end of the year to correct for any over- or under-recovery of indirect costs.

Another alternative to avoid the section 506 prohibition is for the CDBG recipient to substitute unrestricted funds, such as general funds, for CDBG funds made available to the CDC. In addition to general funds, some recipients may have Urban Development Action Grant (UDAG) repayments available as "miscellaneous revenue," i.e. repayments received after project closeout (see 24 CFR 570.461(e)). UDAG repayments must be used for Title I eligible activities (that would include support of business loans), but do not carry the additional restriction, such as compliance with national objectives, that trigger the section 506 provision.

Please provide a copy of this memorandum to all affected CDBG grantees. SBA is providing similar advice to its CDCs (see attached). Any questions on this matter may be addressed to the Entitlement Communities Division of HUD at (FTS)458-1577, or to Martin Orr of SBA Central Office at (FTS) 445-6485 or (202) 205-6485.

Attachment

cc: Edwin I. Gardner, SC

SBA PROCEDURAL NOTICE

NOTICE NO.
TO: Regional Administrators, ARAs/F&I, District 5000-
Directors, Branch Managers, ADDs/F&I, FD
Chiefs, PM Chiefs, and All CDCs EFFECTIVE

SUBJECT: Restriction on Certified Development Companies with respect to HUD-CDBG funding of Administrative Costs

13 CFR 108.506 states that on or after May 1, 1991, no develop-
ment company (CDC) may accept funding from any source if it includes any conditions or restrictions upon (a) the types of small businesses which may receive assistance under SBA's Development Company loan program or (b) the recipient of such assistance. This regulation insures that CDCs are focused on overall economic development goals of job creation and retention through assistance to successful small businesses. CDCs are encouraged to work toward other local and national objectives, and to use the 504 program to achieve those objectives. However, the program is not to be limited beyond the eligibility requirements of Part 108 of SBA Regulations.

This does not preclude a CDC from receiving funding from another source (eg. U.S. Department of Housing and Urban Development). It does require the CDC and funding grantee, if different, to carefully assess (a) how the funds are made available, (b) how they are utilized within overall CDC operations and (c) an analysis of the relative magnitude of restricted funds in comparison to total funding of the CDC's operations. Some suggestions on how CDCs and local grantees can achieve and maintain compliance with the above cited regulation are:
Replacement of Restricted Funds with Unrestricted Funds:
For a CDC with a limited number of program activities, a desirable alternative is to have the local governmental sponsor substitute unrestricted funds (eg. General funds) for restricted funds (eg. CDBG). From a local budgetary perspective, this could result from an exchange of CDBG funds scheduled for the CDC with General Funds scheduled for a project that could otherwise be CDBG eligible.

Replacement of CDBG funds with UDAG Repayments: For CDCs carrying out activities in HUD eligible target areas or activities that are consistent with HUD objectives, an alternative is to have the local governmental sponsor to substitute repayments from UDAG funded projects with the more restrictive CDBG funds. Again, from a local budgetary
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perspective, this could be a swap of a UDAG Repayment project with a CDBG funded project, without adversely affecting local program recipients.

Allocation of Funding Sources Based on Work Activities: For
a CDC carrying out multiple programs based on multiple
funding sources, the CDC and funding sources (or local government sponsor may agree upon proration of funding in relation to work activities. This does not imply that a formal indirect cost accounting system is required. Two approaches are offered.

One approach is based on a CDC maintaining records of staff time by loan or, more likely, program activity (eg. SBA 504, HUD CDBG, general business assistance). The cost of delivering each loan or activity could be prorated to each appropriate account.

The second approach is based on general measures of work effort such as number of loans processed under different lending programs (SBA, CDBG, EDA, state/local etc.), number of companies assisted through other programs or referrals, number of seminars/training programs provided to different client groups, and other economic development activities. For example, a CDC may document that 20% of its effort is for administration of a CDBG funded revolving loan fund and 20% is for an EDA revolving loan fund, it is then reasonable to project that 20% of its funding could be CDBG funds, etc.

In summary, CDCs which are receiving or are considering the receipt of restricted funds need to work with local government sponsors to insure an allocation of funds in relation to the effort(s) required and services provided. HUD is providing similar advice to its field offices (see attached). Any questions on this matter may be addressed to Martin Orr in SBA Office of Economic Development at (FTS) 445-6485 or (202) 205-6485), or to the Entitlement Communities Division of HUD at (FTS) 458-1577

(signed CRH)

Charles R. Hertzberg
Assistant Administrator
for Financial Assistance

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